Behavior Modification

Author Michael Lewis must feel like Yogi Berra with déjà vu all over again. In 1989, as the country was looking in the rear view mirror at a major market crash preceded by a decade of overindulgence, he published "Liar's Poker." His personal account of working at Salomon Brothers in the 1980's told the tale of testosterone-charged bond traders and their relentless pursuit of money and power. The book became an instant classic on Wall Street, and somewhat of a playbook for aspiring Gordon Gekkos. He labeled that era to be a *"rare and amazing glitch"* in the history of earning a living. Today, as we read the emails and listen to the stories of deals constructed during the earlier years of the 2000's, it seems that the "rare" money-making opportunity of the 1980's was not so rare after all.

As our legislators craft the details of financial reform, we think it is important that they focus not just on how to extricate ourselves from the next crisis, but on how to best prevent one. The main goal of this paper is to illuminate the central points of financial reform legislation now being debated in Congress. In order to do that, we must first address the important question: "What led us to this point?" Twenty years after "Liar's Poker" Michael Lewis has published another book, "The Big Short," in which he chronicles the accounts of a handful of investors who bet on and profited from the collapse of the subprime mortgage market. In it, he sums up what we believe is the emotional raw nerve for most people regarding this crisis: *"The problem wasn't that Lehman Brothers had been allowed to fail. The problem was that Lehman Brothers had been allowed to succeed."*

An Ounce of Prevention

Americans are proud of the philosophy of hard work and perseverance on which this country was built. We love to hear the stories of a poor kid who pulled himself up by his broken bootstraps to become a self-made millionaire. Sociological research shows that people in this country instinctively back the underdog. Movies like "The Blindside" and "Rocky" resonate in our culture. In the paraphrased words of E.F. Hutton, Americans want people to make money the old fashioned way…earn it.

The irony is that once people or corporations become *too* successful or dominant in their fields, public opinion can often turn against them, especially if their integrity is called into question. We look for the ways they are cheating the "little guy" by taking unfair advantage of their size or status. Wal-Mart, a classic American success story, today draws scorn and protests for crowding out local businesses despite being our country's largest private employer. Our society measures success by an accumulation of money and power, but there seems to be a point beyond which more power is viewed as a potential *abuse* of power. Attaining success is admirable; attaining too much at others' expense violates our deeply ingrained sense of fairness. Attaining so much power that our society becomes beholden to an institution's success is

Copyright © 2010 Miracle Mile Advisors, LLC

unbearable, and plays into the emotional backlash against the claim that an entity is "too big to fail."

Without a doubt there was significant lying and cheating by a number of players during the recent housing bubble, from the mortgage brokers who misrepresented loan terms to the homeowners who lied on their applications. In the end, however, populist anger has clearly been reserved for the big-gun financial professionals. After all, homeowners would not have had access to subprime loans if the banks had not been offering them; banks would not have been offering the loans if securities firms were not demanding more and more mortgages to package into complicated and profitable derivative instruments. Society holds the professionals accountable partly because they are supposed to be the experts – the best and the brightest; but they are also held accountable in this instance because of the widespread collateral damage their activities engendered. Mortgages were the securities underlying the toxic Collateralized Debt Obligations (CDOs) that sunk the markets and drew so many unsuspecting homeowners into the fray. Homeowners became pawns in a chess match of sophisticated investors who themselves turned out to not really understand the rules that well.

Once all of the banks' records and emails are scrutinized, it is highly possible we may find that the surviving players on Wall Street did nothing technically illegal. As unbelievable as that may seem to the average person, it is a point that lawmakers want to highlight. The spectacle put on in Congress is designed to show the American people that as distastefully as Wall Street behaved, much of what they did violated no current laws, and therefore, those laws must now be put into place. Regulation tends to be reactionary – think airline safety screening. Typically when we regulate an industry under scrutiny, we first plug the obvious holes. Over time, however, history has shown that the "best and brightest" innovate and find a way around the regulations, which is probably unavoidable in an industry full of highly ambitious and intelligent people. The real challenge in creating effective regulation is to provide incentives to adhere to the spirit of the law as well as the letter of the law. Below we discuss the critical issues in establishing lasting reform.

Fiduciary Standards

Since the humble origins of the New York Stock Exchange in the late 18th century, Wall Street has grown from a "start up" of a few traders gathered under a buttonwood tree to a behemoth. It is important to understand that "Wall Street" is far from one homogeneous entity. Into this group we lump investment bankers, proprietary traders, market makers, investment advisors, brokers, mutual fund managers, hedge fund managers and countless others. They serve very different purposes in the financial world, and as a result are governed by different standards. Some of these groups have no obligations other than to maximize profits for their firms, while some are governed by a strict fiduciary responsibility to the client.

Copyright © 2010 Miracle Mile Advisors, LLC

The requirement to act as a fiduciary is the current standard for registered investment advisors, including Miracle Mile Advisors. We are legally required to act in the best interests of our clients and their beneficiaries (similar to a trustee), and to recommend only the best investment options for them. Brokers, however, are not required to act as fiduciaries. Instead, they are only required to recommend investments that are "suitable" for the client, a much lower threshold. Confusion over what this means and who is required to abide by these standards creates a loophole for unethical behavior. The industry needs to do a better job of educating people on this distinction.

Imagine the example of a woman who would like to purchase a television. Her criteria are a minimum screen size of 40 inches and a maximum price of $1,000. When she goes to the electronics store she finds there are two choices that meet those basic needs. The first has a 40" screen and a $999 price tag, but the second has a 42" screen and is on sale for $899. If the quality is equivalent, then both of the TVs are suitable for her, but clearly the second is the better choice. While we hope the salesman would recommend the better deal, he would not be legally restricted from pushing the pricier model. In the investment world, an advisor with a fiduciary responsibility would be required to recommend the second product.

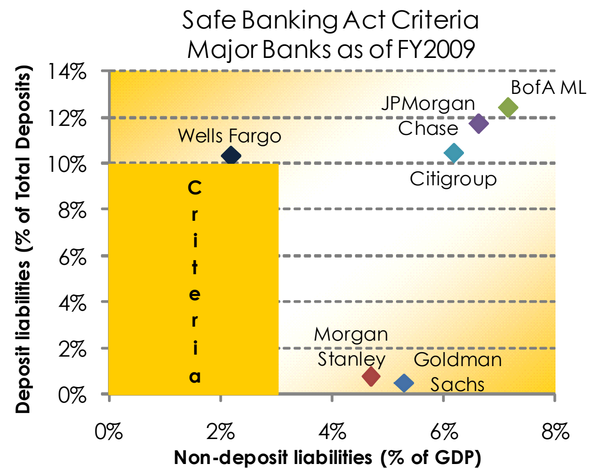
As it stands, the current financial reform bill does not specifically expand fiduciary responsibility. Several Senators, however, are drafting amendments to the bill to broaden fiduciary requirements to broker-dealers and insurance agents, which we believe would be a step toward reducing confusion. Legislators have to proceed carefully in determining who should fall under the scope of fiduciary responsibility. A challenge arises when the financial professional's role is one level (or more) removed from the client. For example, iShares creates and/or distributes many different Exchange Traded Funds with varying fees, risk profiles and underlying investments. Not all of these ETFs are appropriate for every client, but should that prevent iShares from making a broad range of options available? Obviously not; which highlights the importance of making sure a client's advisor is considering his or her best interests.

Too Big to Fail

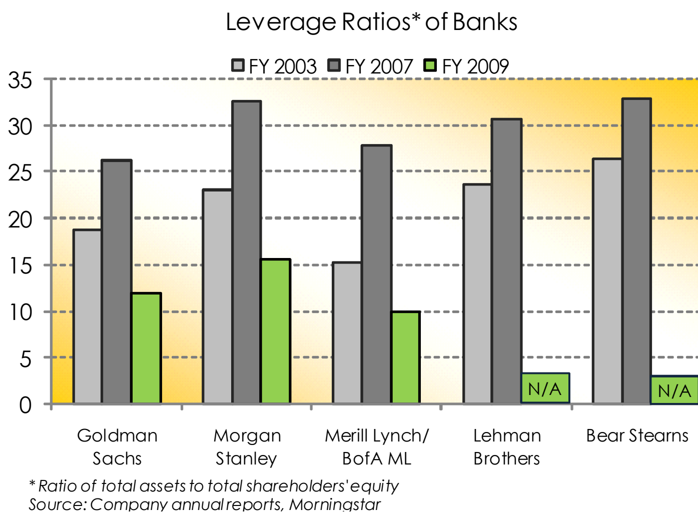
When the credit rating of AIG was downgraded the financial system was between a rock and a hard place. No one really understood what impact the collapse of a firm like AIG would have on its counterparties. We had just experienced the fire sale of Bear Stearns to JPMorgan Chase, and we were in the midst of the bankruptcy of Lehman Brothers and a hasty buyout of Merrill Lynch by Bank of America. To some it seemed to be much too great a risk to take; to others letting it fail seemed the only option. The system should not have been in that gun-to-head situation in the first place.

Copyright © 2010 Miracle Mile Advisors, LLC

The Safe Banking Act, a bill introduced by two Senators from Ohio and Delaware, attempts to address the problem of "too big to fail." The bill would limit a bank to holding less than 10% of all insured deposits, which could reduce the impact of a bank run à la the Great Depression. Just regulating a bank's share of traditional deposits, however, would not provide insulation from the way much lending takes place in the capital markets today, i.e. through securitization. In order to control liabilities that exist in the "shadow banking system," the Act also places a limit on financial institutions' non-deposit-liabilities-to-GDP ratio. Bank holding companies would be required to have less than a 2% ratio, while non-bank institutions like investment banks could have up to 3%. This limit in a sense controls how interconnected a firm could become in the capital markets, and reduces the chances that a single firm could bring down the entire system. Only a handful of the largest banks would currently fall outside of these limits, with about 8,000 banks already compliant (see graph above). The Senators also call for a leverage limit of 6% for bank holding companies and select non-bank financial institutions; in other words lending is capped at just over $16 for every $1 of capital held. The current House of Representatives bill allows a $15/$1 lending ratio. The graph at left shows how much the major players have already brought down their leverage ratios from pre-crisis peaks.



Source: Company annual reports, Morningstar, Roosevelt Institute, Bureau of Economic Analysis, FDIC



*Ratio of total assets to total shareholders' equity
Source: Company annual reports, Morningstar

Derivatives Legislation

Derivatives are one of the hot-button topics of the reform debate. Derivatives are securities whose prices are "derived" from other underlying assets. Common examples of derivatives include futures contracts, forward contracts, and swaps. Derivatives used to be used most often to hedge the risk of future price movements for things like commodities or to hedge currency exposure, but rapid financial innovation helped them become a highly speculative and profitable tool for banks. The recent crisis introduced the non-financial world to the credit derivative through the CDO,

Copyright © 2010 Miracle Mile Advisors, LLC

Collateralized Debt Obligation, which is a security whose value is derived from the credit risk on an underlying group of bonds. **CDOs were the tool used to package together mortgages of varying credit quality and resell them with a AAA stamp of approval from the rating agencies; meanwhile rating agencies are paid by the issuer of the security!** The proposed legislation does address some of the problems with the rating agencies, such as calling for them to register with the SEC and forcing disclosure of conflicts of interest, but these measures are widely viewed as weak.

Derivatives are largely traded on over-the-counter markets with no standard for risk management or disclosure to counterparties. Some regulators are calling for a **clearinghouse** to be established in the derivatives market, which would bring more structure and transparency to trading and lower transaction costs. More transparency in derivatives trading could also reduce the complexity of winding down a firm that has failed, such as in the case of Lehman Brothers.

The language surrounding derivatives regulation in the House bill is benign, but the Senate Agriculture Committee has since taken a stronger lead. A combination of the Agriculture proposal and a Banking Committee proposal calls for any bank dealing in swaps to be barred from both federal deposit insurance and access to the Federal Reserve's emergency borrowing window, and requires most trades to go through exchanges and clearinghouses. Broad consensus has not yet been reached on this issue, but President Obama has promised to veto any bill that does not include strong reform of derivatives trading. It is highly likely that some type of structure will be placed around trading these Warren Buffett-coined "*financial weapons of mass destruction*."

Resolution Authority

If a large firm does ultimately fail, what is the process of unwinding it and who ultimately pays for it? This is the question central to how to structure a resolution authority, which outlines the means and methodology for unwinding a firm. The debate largely deals with a few key topics: **preventing** firms from descending into failure by increasing capital ratios and decreasing leverage, and forcing the resignation of failed management; **identifying** firms that are in danger of failing and guiding them back onto a sustainable path; and **resolving** firms deemed inherently risky to the system without resorting to bankruptcy law.

The most contentious issue is who pays for the unwinding. The House bill originally called for a $150 billion prepaid fund built through payments from firms, while the Senate called for a $50 billion version of the same fund. The Obama administration's original white paper opposes the creation of a fund, a stance also backed by Republicans, and calls for banks to repay the cost after the fact. The latest agreement between Republicans and Democrats drops the fund altogether, paving the way for bipartisan support and the beginning of floor debate in the Senate. In the

Copyright © 2010 Miracle Mile Advisors, LLC

current proposal, the Federal Deposit Insurance Corporation (FDIC) would finance a firm's liquidation by use of a credit line provided by the U.S. Treasury Department. The credit line would be backed by assets of the failed firm and losses repaid through the sale of those assets. The company's shareholders and creditors would bear the brunt of the losses.

The Volcker Rule

The Glass-Steagall Act, repealed under President Clinton in 1999, was put into place during the Great Depression to separate commercial and investing banking activities. In its place, the Gramm-Leach-Bliley Act allowed entities such as commercial banks, investment banks, securities firms and insurance companies to consolidate and expand the range of services offered by a single institution. This paved the way for the creation of conglomerates like Citigroup to offer banking, insurance and securities services.

The "Volcker Rule" is the brainchild of Paul Volcker, former Federal Reserve Chairman and head of the President's Economic Recovery Advisory Board. The Rule as it stands would revive parts of the Glass-Steagall Act and bar banks from investing in, owning, or sponsoring hedge funds or private equity firms. It would essentially force bank holding companies to spin off their proprietary trading businesses. Invoking fiduciary standards, Volcker was quoted in a speech as saying, "*We ought to have some very large institutions whose primary purpose is a kind of fiduciary responsibility to service consumers, individuals, businesses and governments by providing outlets for their money and by providing credit. They ought to be the core of the credit and financial system. Those institutions should not engage in highly risky entrepreneurial activity.*"

Since the Volcker Rule was announced after the passage of the House bill, it is not included. The original bill in the Senate had weak language around the Rule, calling for regulators to "study" its implementation. Two Senators have since proposed an amendment that strengthens the Rule regarding conflicts of interests. At this point, it is uncertain how this issue will be resolved.

Consumer Protection

Consumer protection is a divisive issue and also seen as the one most likely to derail reform. Many lawmakers agree, however, that the current landscape consisting of ten different agencies responsible for various portions of consumer financial protection is untenable. Legislators' views of how regulators should be involved with consumers' right in private industry largely follow traditional partisan lines. Democrats are calling for a Consumer Financial Protection Bureau to be created within the Financial Reserve. The Bureau would be charged with protecting consumers from abusive practices in the mortgage, credit card and lending industries, and it would be able to ban certain financial products. Some examples would be phasing out penalties charged to homeowners who pay down their mortgages early, and limiting certain

Copyright © 2010 Miracle Mile Advisors, LLC

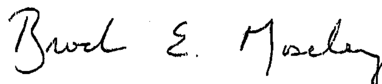
kinds of credit card fees. The Bureau would have oversight of the largest banks as well as unregulated financial firms like mortgage originators. Regional banks and credit unions would also be subjected to the rules, but their existing regulators would be responsible for enforcement. Opponents of this plan fear that an overarching regulator could effectively limit consumer choice and impede the free flow of capital.

The Republican plan, voted down in the Senate this week, houses consumer protection within the Federal Deposit Insurance Corporation. The plan focuses on non-banking mortgage originators as well as financial firms that are repeat offenders of consumer protection laws, and exempts most banks, credit unions, and auto lenders from new regulations. Democrats feel that the Republican proposal would leave consumer protection standards even weaker than they stand now.

Broad Support for Reform

Financial regulation is an incredibly complicated topic and this summary touches only the tip of the iceberg. Political wrangling aside, both parties agree that reform is needed and a bill in some form will be passed. Even Wall Street CEOs have publicly jumped on the bandwagon as the SEC's lawsuit against Goldman Sachs turned the politics of reform upside down. Goldman Sachs CEO Lloyd Blankfein recently said, *"The biggest beneficiary of reform is Wall Street itself,"* while JPMorgan Chase CEO Jamie Dimon was quoted as saying, *"It's obvious we need to reform our financial system. JPMorgan has supported most of the things that came out."* Not all of the new regulation will do what is needed or even intended, but hopefully it will be a step toward addressing some of the behaviors that led to a potential melt down of the financial system.

May 7, 2010



Katherine Krantz
Chief Economic Strategist

Brock E. Moseley
Chief Investment Officer

Copyright © 2010 Miracle Mile Advisors, LLC

Disclosures

The views of Miracle Mile Advisors, LLC ("MMA") may change depending on market conditions, the assets presented to us, and your objectives. This research is based on market conditions as of the printing date. The materials contained above are solely informational, based upon publicly available information believed to be reliable, and may change without notice. MMA makes every effort to use reliable, comprehensive information, but we make no representation that it is accurate or complete. We have no obligation to tell you when opinions or information in this report change.

MMA shall not in any way be liable for claims relating to these materials, and makes no express or implied representations or warranties as to their accuracy or completeness or for statements or errors contained in, or omissions from, them.

This report does not provide individually tailored investment advice. It has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. The securities discussed in this report may not be suitable for all investors. MMA recommends that investors independently evaluate particular investments and strategies, and encourages investors to seek the advice of a financial adviser. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives.

This report is not an offer to buy or sell any security or to participate in any trading strategy. In addition to any holdings that may be disclosed above, owners of MMA may have investments in securities or derivatives of securities mentioned in this report, and may trade them in ways different from those discussed in this report.

The value of and income from your investments may vary because of changes in interest rates or foreign exchange rates, securities prices or market indexes, operational or financial conditions of companies or other factors. There may be time limitations on the exercise of options or other rights in your securities transactions. Third-party data providers make no warranties or representations of any kind relating to the accuracy, completeness, or timeliness of the data they provide and shall not have liability for any damages of any kind relating to such data.

The information and analyses contained herein are not intended as tax, legal or investment advice and may not be suitable for your specific circumstances; accordingly, you should consult your own tax, legal, investment or other advisors, at both the outset of any transaction and on an ongoing basis, to determine such suitability. Legal, accounting and tax restrictions, transaction costs and changes to any assumptions may significantly affect the economics of any transaction. MMA does not render advice on tax and tax accounting matters to clients. This material was not intended or written to be used, and it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer under U.S. federal tax laws.

The projections or other information shown in the report regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results.

Other Important Disclosures

Physical precious metals are non-regulated products. Precious metals are speculative investments and, as such, their value can be subject to declining market conditions.

Real estate investments are subject to special risks, including interest rate and property value fluctuations as well as risks related to general and local economic conditions.

Foreign/Emerging Markets: Foreign investing involves certain risks, such as currency fluctuations and controls, restrictions on foreign investments, less governmental supervision and regulation, and the potential for political instability. In addition, the securities markets of many of the emerging markets are substantially smaller, less developed, less liquid and more volatile than the securities of the U.S. and other more developed countries.

This report or any portion hereof may not be reprinted, sold or redistributed without the written consent of MMA.

Additional information on recommended securities is available on request.

Copyright © 2010 Miracle Mile Advisors, LLC